

TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Finalize Board Conflicts/Disclosure Regulation

ITEM NUMBER: 9

CONSENT: _____

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: September 6, 2007 / 30 mins.

INFORMATION: _____

PRESENTER(S): Kathleen Andleman

PURPOSE:

The purpose of this item is to discuss the proposed campaign contribution regulations and to determine how the Board wishes to proceed.

BACKGROUND AND DISCUSSION:

At its meeting on December 7, 2006, the Board Governance Committee approved proposed regulations addressing the disclosure of campaign contributions. The Committee authorized staff to proceed with the rulemaking process in accordance with the Administrative Procedure Act. Hearings were held and written comments were received from members of the public. In response to the comments and in response to concerns raised by CalSTRS Investment Staff, the regulations were substantially revised.

At its meeting on June 7, 2007 the Board authorized Staff to further revise the proposed regulations and to post those revised regulations for further public comment. The revisions made to the proposed regulations were as follows:

- Section 24010(a): The contribution limit was modified to reflect an individual limit of \$1,000 and an aggregate limit of \$5,000.
- Section 24010(b) was modified to include a reference to a new section 24011.
- Section 24010(e): The last portion of the paragraph was modified to change the word "ends" to "terminated." It now reads: "and ends when the Investment Relationship is terminated ..."
- A new section 24011 was added to incorporate suggested recusal and disclosure language. This section also addresses quorum issues.
- Section 24012 (formerly Section 24011) was modified to reference the new Section 24011 and to include a safe harbor provision.

After several discussions with staff at the Office of Administrative Law (OAL), it was determined that the changes made fell within the “sufficiently related” provision of the Office of Administrative Law’s regulations to allow for a 15 day notice period. The revised version of the proposed regulations (Attachment 1) was posted on the CalSTRS website on Friday, June 29, 2007 and the public was offered an opportunity to submit comments by July 27, 2007. Additionally, CalSTRS business partners were contacted and made aware of the status of the regulatory process. Four comments were received (Attachment 2). After reviewing the comments, Staff is not recommending any further revisions to the proposed regulations.

If the Board authorizes staff to move forward with the rulemaking process, the next step will be to submit documentation to OAL for its review. OAL will have 30 working days to review the proposed regulations. If OAL determines that the regulations satisfy the rulemaking requirements of the Administrative Procedures Act (APA), they will be filed with the Secretary of State. The regulations will become effective 30 days thereafter.

If OAL reviews the proposed regulations and finds that they do not satisfy rulemaking requirements, OAL can return the regulations to CalSTRS. CalSTRS may revise the text of the proposed regulations. If there are substantial changes sufficiently related to the original proposal CalSTRS can conduct a 15 day comment period and then resubmit the proposed regulations to OAL within 120 days. A new 45 day public notice and comment period will be required if the revisions are not sufficiently related to the regulations.

A summary of the four comments received and Staff responses to those comments are set forth below.

1. James McRitchie, Publisher, Corporate Governance: Amend Regulation to Account for Investigating Violations by the General Counsel

Mr. McRitchie wrote to support adoption of the revised regulations, but suggested that the regulations be further amended to take into account the possibility of violations by the General Counsel.

Response: While the revised proposed regulations place responsibility for initiating investigations with the General Counsel, the proposed regulations require that it be an “independent investigation.” It is anticipated that the General Counsel will not actually perform the investigation, but rather cause an investigation to be initiated. To the extent the General Counsel is being investigated, the regulations would still require that an “independent investigation” be performed, thereby eliminating the possibility that the General Counsel could investigate him or herself.

2. Dennis T. Byrne, Goldman Sachs: Is the Regulation Prospective Only?

Mr. Byrne asked whether the proposed regulations are intended to be prospective, or if they would require the amendment of existing investment contracts.

Response: The regulations are prospective; CalSTRS will not be amending any contracts to attempt to make them retroactive.

3. California Chamber of Commerce on behalf of a coalition of business groups (Coalition)

The Coalition reiterated some of the concerns it had submitted in response to the earlier draft of the regulations. Staff's responses to the previous comments were provided to the Board for its June 2007 meeting.

Adverse Economic Impact: The Coalition states the regulations pose a threat to California's economy, will limit competition, and threaten other industries.

Response: As noted in the response made previously, it is not entirely clear how these regulations threaten California business or impose more than a whisper of a burden on any entity seeking an investment relationship with CalSTRS. As a threshold matter, the investment business is already a highly regulated area, and the additional reporting required by these regulations is slight. While the commenter has expressed a concern that if the regulations are successful they may spread to other agencies, it is still not clear how this would create an adverse economic impact. As noted above, in response to comments the regulations were significantly narrowed in scope and the aggregate dollar contribution amounts were increased. The revised proposed regulations target the core source for potential pay-to-play abuse in a public pension fund: investment transactions. While there is a slight additional transactional cost associated with tracking and reporting contributions, there are no other direct economic impacts on the regulated entities.

Lack of Authority: The Coalition states there is no authority for the regulations.

Response: As discussed in the responses prepared previously, the Teachers' Retirement Board has both a fiduciary obligation and the statutory authority to promulgate regulations designed to ensure that investment decisions are made free from conflicts of interest or the perception of a conflict of interest. Pay-to-play decision making in public pension funds has been a national issue and one that has received considerable media attention. The Board's promulgation of these regulations is supported by its statutory and constitutional authority and fiduciary obligations associated with its plenary management of the Teachers' Retirement Fund.

The Regulations Conflict with Proposition 34: The Coalition asserts the regulations directly conflicts with Proposition 34, the Political Reform Act. The basis for this appears to be the lower dollar amount limits.

Response: While pointing to several differences between the proposed regulations and the Political Reform Act, the commenter has not actually pointed to anything that would be a conflict under Government Code section 81013. As section 81013 specifically authorizes the imposition of additional requirements on parties subject to the Political Reform Act, as long as the additional requirements do not preclude compliance with the Act, absent a showing that the new campaign limits would preclude such compliance, there is no inherent conflict between the proposed regulations and the Political Reform Act. Differing requirements alone do not create a conflict, despite the commenter's suggestion to the contrary. For example, many of the parties covered by the proposed regulations are already subject to stricter campaign contribution limits under Education Code section 22363, which will continue to govern investment decisions made by the Board in closed session.

Lack of Reference: The Coalition asserts that sections of the Education Code cited as reference for the regulations do not support adoption of the proposed regulations.

Response: "Reference" means the statute, court decision, or other provision of law which the agency implements, interprets, or makes specific by adopting, amending or repealing a regulation. Education Code section 22250 requires that members of the Board discharge their duties, "(b) With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in like capacity and familiar with those matters would use in the conduct of an enterprise of a like character and with like aims." It is undisputed that the Board engaged in extensive fact finding on how to meet its fiduciary obligations under this section in regard to pay-to-play campaign contribution issues. This proposed regulation is a direct result of this fact finding and a direct implementation of the Board's obligation to act with, "care, skill, prudence and diligence." It is unclear how the Board would be able to carry out this provision without engaging in policy and rule making.

The Regulation Lacks Clarity: The Coalition asserts the revised proposed regulations lack clarity. While noting the original proposed regulations have been modified (partially in response to the comments submitted by the Coalition to the original proposed regulations), the commenter still finds that removal of the terms "direct" or "indirect" in the context of making contributions leaves ambiguity as to the application of the regulations. Further, the Coalition states that the term "seeking" is unclear in the context of seeking an investment relationship. The Coalition also asserts the language should be presumed unclear.

Response: The use of the terms "direct" or "indirect" in the original proposed regulations was intended to recognize that parties often do direct others to make contributions on their behalf. As pay-to-play transactions are the focus of these regulations, the Board believed it necessary to address the obvious methods of engaging in pay-to-play, including directing a third-party to do something on a contributor's behalf. Given the recent experience of the Board as a plaintiff in securities litigation involving extensive allegations of sham third-party and round trip transactions, the Board is exceedingly cognizant of the ability to engage in improper activity through the clever use of third parties.

Recognizing, however, that the use of the terms “direct” and “indirect” had caused confusion in the original proposed regulations, the text of section 24010 was revised to add clarity. This revision included identifying with particularity the parties to whom the prohibition applies, and then noting the prohibition also applies to contributions made at the direction of these parties. While the commenter appears confused by this revision and argues that it is inconsistent with the original proposal, this language gives clarity to the parties being regulated and clearly states the prohibition also applies to contributions made from these parties or at the direction of these parties.

The concern by the Coalition over the revision to “seeking” seems strained. The Coalition appears to be arguing that a party can become subject to the regulation by the announcement of a RFP from CalSTRS. As drafted, however, the RFP triggering date only applies when a party could anticipate generating \$100,000 in annual income from participating in an investment-related RFP. Further, the RFP must be likely to lead to \$100,000 in annual income to the party.

The other triggering event seems quite clear. A party soliciting CalSTRS for investment related business becomes subject to the regulations.

While the Coalition asserts that the language should be “presumed unclear,” it has not provided a basis for establishing or relying upon such a presumption.

The Regulations are Unnecessary and Duplicative: The Coalition places great weight on the initial statement of reasons noting that there were no allegations of impropriety associated with campaign contributions at CalSTRS being addressed by the proposed regulations. Therefore, it maintains the regulations are unnecessary. The Coalition also notes that current law addresses campaign contributions and fiduciary obligations. Finally, it contends that internal policies adopted in the Board Policy Manual adequately address the issues that are the focus of the revised proposed regulations.

Response: While no reported instances of campaign contribution abuse tied to pay-to-play investments were discussed during the initial deliberations of the Board, CalSTRS has been the subject of other investment scandals. As Sacramento Bee columnist Dan Walters observed in a column published on February 18, 2000, the case of former Teachers’ Retirement Board member Gilbert Chilton involving dubious oil field investments, “underscores the potential for scandal that always looms in a big public pension fund.”

The Board heard testimony from pension, fiduciary and government ethics experts. The Board heard what other states were doing to address the pay-to-play issue, an issue that had reached a high level of national media focus and become a topic of constant discussion and debate in the public pension world. The Board is compelled by statute and the state constitution to act with care, skill, diligence and prudence. The Board, after extensive fact finding, concluded the most prudent course for addressing the threat of tainting investment transactions with even the hint of pay-to-play or quid pro quo decision making associated with campaign contributions was to place reasonable limits upon such contributions to members of the Board, candidates for the

Board, including ex officio members, and upon the appointing authority for six out the twelve members of the Board.

4. California Bankers Association

Concern about the Need for the Regulation: Noting that the proposed regulations are to deter anticipated conflicts, the California Bankers Association questions why existing laws and regulations intended to enforce the duty of loyalty and to bar conflicts are inadequate to address pay-to-play investment decisions.

Response: Regulations are intended to implement, interpret, make specific or otherwise carry out the provisions of a statute. The proposed regulations are designed to close a perceived vulnerability in the Board's exercise of its discretion in making investment decisions. The perceived vulnerability, the potential for pay-to-play or quid pro quo decision making, would not be an issue but for the requirements of the Education Code and the California Constitution for the Board members to discharge their duties with "care, skill, prudence and diligence **under the circumstances then prevailing** that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims." (Cal.Const., art. XVI, § 17, emphasis added.) After reviewing the matter for over a year, the Board determined that it was necessary to put regulations in place as a safe guard in investment decision making, and as an exercise of the requirement to act as directed by the Education Code and the California Constitution. Rather than conclude that existing statutes were adequate to address pay-to-play, the Board concluded that existing statutes required the Board to be proactive and specific in addressing pay-to-play issues.

Concern with Disqualification: The California Bankers Association also expressed concern about the effective date of the regulations and whether a party having made a contribution prior to the effective date but within the proceeding twelve months would be disqualified from engaging in an investment relationship with CalSTRS or trigger the prospective ban for those already engaged in an investment relationship with CalSTRS.

Response: The proposed regulations are prospective, and although there was some suggestion of including a look back period, this was not incorporated in the regulations. The prohibitions in the regulations are prospective, with the triggering date being tied to either the release of an RFP or the solicitation of business. The triggering date events also trigger the twelve month period limits.

Concern about the Triggering Event: While expressing support for the concept of what CalSTRS is attempting to accomplish, the California Bankers Association noted it concurred in the comments submitted by the California Chamber of Commerce on behalf of the coalition of business groups. The Bankers Association expressed concern that the triggering events for when a party would be subject to the regulations seemed unclear.

Response: As noted above, the revised regulations are specific about the parties covered and the triggering events that would cause the prohibitions contained in the regulations to attach to a particular investment transaction. While CalSTRS is not insensitive to the Bankers Association note that the regulations have not specified whether \$100,000 annually in income, fees or other revenue refers to gross or net, the intent of the regulations is to cover a gross transaction of \$100,000 or more. This intent seems clearly embodied by the present language.

Violation of Proposition 34: The Bankers Association also asserts the proposed regulations violate the Political Reform Act. The substance of the Association's complaint, however, seems to be that the proposed regulations may limit participation in the political process for some of the Association's members with regard to certain office holders.

Response: While the regulations will clearly limit contributions from those seeking an investment relationship with CalSTRS, the regulations still provide for parties to make substantial contributions of \$1,000 individually or \$5,000 in the aggregate. While the Association asserts the regulations' contribution amounts may discourage some of its members from doing business with CalSTRS, CalSTRS believes it is more likely that such an investment decision would be motivated by the fiduciary duty the members of the Association owe their shareholders and investors as opposed to tangential political concerns over how much can be contributed to a particular campaign.

The New Recusal Provision is Unnecessary: While observing that the addition of section 24011, a recusal provision applicable to all employees, officers and Board members of CalSTRS, is in principal a sensible conflict of interest provision if it were more limited, the Bankers Association questions the need for the provision and is concerned that it may severely limit the participation of ex officio members on the Board.

Response: The recusal and disclosure provision was added to provide additional transparency to CalSTRS investment decision making. The provision is in harmony with existing statutory requirements for recusal on designated transactions. The provision will afford staff, officers and Board members a mechanism for withdrawing from transactions when their participation might be perceived as being influenced by campaign contributions.

The Regulation is Not Authorized: The Bankers Association believes the revised proposed regulations conflict with the Political Reform Act, and are therefore unauthorized. The Bankers Association places great emphasis on the failure of staff to include the entire text of the Government Code section 81013 in the statement of reasons.

Response: While the Board believes Government Code section 81013 provides authority for governmental agencies, including CalSTRS, to adopt additional requirements related to campaign contributions, it must be noted that the Board is attempting to regulate investment transactions, not political fund raising. It is in the areas of investments and the fiduciary duty owed to the retirement fund and the members from which the Board draws its authority and in which it places its emphasis in these regulation. While a recusal provision has been added, the

Regular Meeting – Item 9
September 6, 2007
Page 8

main thrust of the revised proposed regulations continues to be placing reasonable limits on campaign contributions made to Board members, prospective Board members, or those that appoint Board members, by persons or entities seeking substantial investment relationships with CalSTRS in order to safeguard against any undue influence or the perception of undue influence and pay-to-play decision making in investment transactions.